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Cabinet Adopts Austere FY 1987 Budget

On December 30 the cabinet adopted a general account budget for FY 1987 (beginning April 1, 1987) that will raise total spending a miniscule 0.02 percent in nominal terms over the initial budget for the current fiscal year. It is the smallest increase in 32 years, a reflection of Prime Minister Yasuhiro Nakasone's determination to reduce the deficit. Substantial increases, however, are penciled in for official development assistance and defense spending (see article in this issue). With more than 300 seats in the 512-member lower house of the Diet, approval of the budget bill is assured.

The general account budget (discretionary expenditures, transfers to local governments and debt service costs) is set at Y54,101 billion ($338.1 billion at Y160=$1.00) in FY 1987 (see Table 1), a slight increase of Y12.4 billion ($77 million). Increased debt service costs, which are expected to account for 20.9 percent of total spending, more than offset declines in discretionary spending and transfers to local government. On the revenue side,

the government expects a 1.6 percent rise in tax receipts to offset a decline in non-tax revenues and allow a modest reduction in government bond issues (see Table 2). These figures, though, are based on 3.5 percent real growth in FY 1987, which many private economists believe is too optimistic.

Table 1: Japan's General Account Expenditures, FY 1986-FY 1987

(initial budgets in millions of yen)

	FY 1986	FY 1987	Change
Debt Service	Y11,319,518	Y11,333,500	0.1%
Local Government Transfers	10,184,955	10,184,100	-0.0
Nondiscretionary	21,504,473	21,517,600	0.1
Social Security	9,834,555	10,089,556	2.6
Public Works	6,223,344	6,082,412	-2.3
Education and Science	4,844,516	4,849,687	0.1
Defense	3,343,549	3,517,434	5.2
Pensions	1,850,139	1,895,612	2.5
Economic Cooperation (Official Development Assistance)	623,244 (622,000)	649,228 (658,000)	4.2 (5.8)
Energy Measures	629,680	495,231	-21.4
Small and Medium Enterprises	205,218	197,348	-3.8
Food Control Account	596,188	540,580	-9.3
Other Operating Expenses	4,083,737	3,916,281	-4.1
Debt Reserves	350,000	350,000	0.0
Discretionary	32,584,170	32,583,400	-0.0
Total	54,088,643	54,101,019	0.0

Table 2: Japan's General Account Revenues, FY 1986-FY 1987

(initial budgets in millions of yen)

	FY 1986	FY 1987	Change
Tax and Stamp Revenues	Y40,560,000	Y41,194,000	1.6%
Non-Tax Revenues	2,582,643	2,406,000	-6.8
Government Bonds	10,946,000	10,501,000	-4.1
Deficit-Financing Bonds	5,246,000	4,981,000	-5.1
Construction Bonds	5,700,000	5,520,000	-3.2
Total	54,088,643	54,101,019	0.0

In drafting the budget policymakers confronted the conflicting goals of boosting domestic demand and improving deficit-ridden government finances. The latter objective is reflected in the cuts slated for many government programs that will result in a fifth consecutive decline in discretionary spending (see Table 3). Other than defense and foreign aid, the only major rise came in

spending for pensions and social security, reflecting the aging of Japan's population. Social security expenditures in FY 1987 are scheduled to top Y10 trillion ($62.5 billion) for the first time.

Table 3: Growth of General Account Expenditures, FY 1976-FY 1987

(change in initial budget)

Fiscal Year	General Account	National Debt Service	Local Government Transfers	Discretionary Expenditures*
1976	14.1%	60.2%	-13.6%	18.8%
1977	17.4	41.1	21.3	14.5
1978	20.3	37.2	16.8	19.2
1979	12.6	26.6	-2.0	13.9
1980	10.3	30.2	23.8	5.1
1981	9.9	25.3	23.5	4.3
1982	6.2	17.7	14.2	1.8
1983	1.4	4.6	-20.8	-0.0
1984	0.5	11.7	21.5	-0.1
1985	3.7	11.7	9.0	-0.0
1986	3.0	10.7	5.1	-0.0
1987	0.0	0.1	-0.0	-0.0

*Discretionary spending equals the general account minus debt service costs and transfers to local governments.

Table 4: Public Bond Issues, FY 1976-FY 1987

(in billions of yen, initial budget)

	Bond Issues		Dependence**		Outstanding Debt		Debt Service	
FY	Total*	Deficit-Financing	Total	Deficit-Financing	Total	Percent of GNP	Total	Percent of Spending
1976	Y7,275	Y3,750	29.9%	19.3%	Y22,076.7	12.9%	Y1,664.7	6.9%
1977	8,480	4,050	29.7	17.8	31,902.4	16.8	2,348.7	8.2
1978	10,985	4,935	32.0	18.4	42,615.8	20.4	3,222.7	9.4
1979	15,270	8,055	39.6	27.1	56,251.3	25.0	4,078.4	10.6
1980	14,270	7,485	33.5	22.0	70,509.8	28.8	5,310.4	12.5
1981	12,270	5,485	26.2	14.4	82,273.4	31.7	6,654.2	14.2
1982	10,440	3,924	21.0	9.5	86,482.2	35.4	7,829.9	15.8
1983	13,345	6,980	26.5	16.6	109,694.7	38.6	8,192.5	16.3
1984	12,680	6,455	25.0	15.2	121,693.6	40.1	9,155.1	18.1
1985	11,680	5,730	22.2	12.8	134,431.4	41.9	10,224.1	19.5
1986	10,946	5,246	20.2	11.3	145,400.0	43.4	11,319.5	20.9
1987	10,501	4,981	19.4	9.2	152,400.0	43.5	11,333.5	20.9

*Includes both construction and deficit-financing bonds.
**As percent of total revenues.

Tokyo's spending restraint will allow it to reduce the ratio of government bond issues to total revenues to 19.4 percent in FY 1987, the first year since FY 1975 that the figure has come in under 20 percent (see Table 4). It is unlikely, however, that the government will be able to end the practice of financing the budget through issues of deficit-covering bonds by FY 1990. The Y265 billion ($1.7 billion) cut scheduled for next fiscal year is far below the Y1.3 trillion ($8.1 billion) annual reduction necessary to reach the target.

The government is relying on the Fiscal Investment and Loan Program, the so-called "second budget" that is financed primarily by postal savings and public pension funds, to stimulate the economy. The FILP budget will increase 22.2 percent to Y27,081 billion ($169.3 billion), its largest increase since FY 1973. This hike will raise total expenditures 6.5 percent in FY 1987 -- up from an initial 3.9 percent gain in FY 1986, with combined outlays on public works expected to rise at least 5 percent, according to Finance Minister Kiichi Miyazawa. Some business leaders, though, were critical of the government's efforts. Noboru Gotoh, president of the Japan Chamber of Commerce and Industry, said the budget was not sufficiently stimulative to counter the deflationary impact of the yen's appreciation.

Randall S. Jones

FY 1987 Defense Spending: Not Exactly Through The Ceiling

The initial FY 1987 defense budget will increase spending to the point where it will at last exceed 1 percent of the country's gross national product, although barely. If economic growth forecasts prove correct, total defense spending for the fiscal year will reach 1.004 percent, just slightly higher than this fiscal year's level, which is estimated at 0.997 percent.

The change at this point is more significant for its symbolic importance and its potential impact on other aspects of Japan's defense policy than because of its financial impact. In bringing the defense budget to this level, the Ministry of Finance agreed to restore Y37.9 billion ($236.9 million at Y160=$1.00) that had been cut from the Japan Defense Agency's request. Although the final figure is less than the agency requested, it is likely to keep the government's Y18.4 trillion ($115 billion) five-year defense procurement plan on track for the second year. It will also allow JDA to make decisions in several key areas, including the FSX project -- the next-generation fighter support aircraft to replace aging F-1s and F-4s. Furthermore, it maintains the overall pattern of consistent defense spending increases, in contrast to many of Japan's Western allies.

Total defense outlays are set at Y3,517.4 billion ($22 billion), a 5.2 percent increase over FY 1986's initial budget. The budget includes funding for purchases of additional Patriot surface-to-air missile units; 12 of 15 requested F-15J interceptors; three C-130 transport aircraft; and 20 of 23 requested T-4 trainer aircraft. Thirty-six percent of the budget will be allocated to purchases of military equipment, a significant hike. Almost 44 percent will be earmarked for personnel costs. The Ground Self-Defense Forces will receive 36.6 percent of the total, the Air SDF 25.5 percent and the Maritime SDF 24.5 percent. These figures suggest a gradual shift to the MSDF in

Tax Reform Plan Clears Another Hurdle

Tax reform in Japan moved a step closer to implementation December 23 when the Liberal Democratic Party's Tax System Research Commission approved the details of the first major overhaul of the nation's tax code in 36 years. The package contained no major new wrinkles (see JEI Report No. 44B, December 5, 1986, and No. 46B, December 19, 1986), but this familiarity does not guarantee smooth sailing for the government's tax reform bills in the Diet. Opposition party officials have already put LDP leaders on notice that they plan to fight the proposed introduction of a broad-based sales tax modeled after the European Community's value-added tax. There could also be a backlash when voters and corporate executives figure out that the plan, while revenue neutral on paper in both FY 1987 and FY 1988, spells higher total tax payments for many individuals in FY 1988 and later years and for a long list of businesses right from the start.

Like the tax reform plan adopted last summer by the United States, the overhaul of Japan's tax system proposed by the LDP tax panel features cuts in both personal and corporate income taxes. Individual income taxes at the national and local levels will be trimmed by an estimated Y1,270 billion ($7.9 billion at Y160=$1.00) in 1987 and by an additional Y1,430 billion ($8.9 billion) or so in 1988. These cuts will be achieved in large part by reducing the number of taxable income brackets in the national tax code from the current 15 to 13 this year and 6 in 1988 and by lowering the marginal rates applicable to all tax brackets in two steps (see Table). Unlike the situation in the United States, local governments will alter their personal income tax structures in tandem with the national government.

Japan's business community also won its long-running campaign for lower statutory corporate income tax rates. Over the FY 1987-FY 1989 period companies capitalized at Y100 million ($625,000) or more with a taxable income in excess of Y8 million ($50,000) will see the rate at which retained earnings are taxed drop from 43.3 percent to 37.5 percent. Although the FY 1989 rate will still be above the pre-FY 1975 level, companies are expected to save a total of Y1,800 billion ($11.3 billion) over the next three years.

Since government and LDP policymakers were in agreement that any overhaul of the tax code must be revenue neutral, tax planners were saddled with the tough job of finding ways to make up the Y4,500 billion ($28.1 billion) revenue loss expected from the cuts in personal and corporate income taxes. Introduction of a major new indirect tax was the top candidate from the start, but just the mention of this option triggered the same storm of criticism that had torpedoed previous government attempts to narrow the yawning budget deficit by enacting a new sales tax. This time around, though, the LDP tax council, like the government's tax panel before it, decided to bite the bullet.

Included in the tax reform package approved by the LDP's tax commission is a 5 percent value-added or sales tax that will be applied at each stage of the production process and on most service-sector transactions starting on January 1, 1988. To make the tax more politically palatable, the group opted to exclude from coverage a total of 43 items that can be generally described as basic living costs -- for example, food, rent, public transportation, education, medicine and medical care covered by the national health insurance system. Companies with annual sales of Y100 million ($625,000) or less will also be exempted from the system.

Proposed Tax Changes for FY 1987

Tax Cuts

National Taxes	
Personal Income Taxes	¥1,000 billion
• Reduction in the number of taxable income brackets from 15 to 13 effective January 1987	
• Cuts in marginal tax rates above the minimum 10.5 percent rate (taxable income of ¥0.5 million or less), with the maximum rate dropping from 70 percent to 60 percent on taxable income over ¥50 million as of January 1987	
• Deduction of ¥112,500 in spousal taxable income for a married couple with a taxable income of less than ¥8 million	
Corporate Income Taxes	400 billion
• Reduction of the basic tax rate for retained earnings from 43.3 percent to 42 percent	
• Increase in the basic tax rate for distributed earnings from 33.3 percent to 34 percent	
Local Taxes	
Personal Income Taxes	270 billion
• Reduction in the number of prefectural and municipal taxable income brackets from 15 to 11	
• Cuts in marginal tax rates above the minimum, which will go up from 4.5 percent to 5 percent, with a new top rate of 17 percent instead of 18 percent	
• Increase in the exemption (credit) for taxpayer, spouse and dependents from ¥260,000 each to ¥280,000 each	
Corporate Income Taxes	70 billion
Total	1,740 billion

Tax Increases

National Taxes	
Taxes Paid by Individuals	750 billion
• Introduction of a 5 percent value-added (sales) tax January 1, 1988 (¥650 billion)	
• Surcharge of 6 percentage points on value-added (sales) tax on motor vehicles starting January 1, 1988 (¥50 billion)	
• Introduction of a 20 percent withholding tax on interest income from postal savings and bank time deposits effective October 1, 1987 (¥50 billion)	
Taxes Paid by Businesses	650 billion
• Changes in the securities transaction tax, registration and license tax and other business taxes (¥300 billion)	
• Phase-out of tax-free reserves for bonuses (¥350 million)	
Total	1,400 billion

Proposed Tax Cuts for FY 1988

National Taxes

Personal Income Taxes

- Reduction in the number of taxable income brackets from 13 to six effective January 1988
- Cuts in marginal tax rates as of January 1988, with the minimum rate (taxable income of ¥1.2 million or less) going to 10 percent and the maximum rate (taxable income over ¥15 million) dropping to 50 percent
- Deduction of ¥150,000 in spousal taxable income for a married couple with a taxable income of less than ¥8 million

Corporate Income Taxes

- Reduction of the basic tax rate for retained earnings to 40 percent
- Increase in the basic tax rate for distributed earnings to 35 percent

Local Taxes

Personal Income Taxes

- Reduction in the number of prefectural and municipal taxable income brackets to four
- Cuts in marginal tax rates above the minimum 5 percent rate, with a top rate of 15 percent
- Deduction of ¥120,000 of spousal taxable income

Proposed Tax Cuts for FY 1989

National Taxes

Corporate Income Taxes

- Reduction of the basic tax rate for retained earnings to 37.5 percent
- Increase in the basic tax rate for distributed earnings to 37.5 percent

Despite these exclusions, the four major opposition parties have come down hard on the LDP, accusing Prime Minister Yasuhiro Nakasone of violating his July 1986 campaign pledge not to back the introduction of a major new indirect tax. Even some members of the premier's own party are said to oppose the sales tax plan. Business leaders can be expected to fan this opposition since they are convinced that many if not most companies will have trouble passing on the full tax in the form of higher prices.

An equally controversial proposal to reform Japan's much-abused small savings system effective October 1, 1987 has also produced a backlash. According to the LDP tax council plan, the tax-exempt status of interest income earned on postal savings and bank accounts of up to Y3 million ($18,750) will be eliminated for all taxpayers except senior citizens, handicapped people and single-parent families, replaced by a 20 percent withholding tax. The nontaxable status of interest income from several other sources will also be changed this October if the party panel has its way.

Susan MacKnight

Special Diet Session Wraps Up; Regular Session Convenes

The extraordinary session of the Diet, which concluded December 20, was quickly followed by the convocation of the regular 150-day session December 29. The special session may be long remembered for its enactment of legislation reorganizing the Japanese National Railways as a group of private systems, the last measure in a series of steps to privatize quasi-government corporations and thereby reduce government spending. Among the 24 bills approved during the session was a measure increasing costs to individuals covered by the national health insurance program, another item directed at containing government expenditures.

The 101-day extraordinary session was held in accordance with the constitutional requirement that such a session follow the dissolution of the Diet and subsequent elections. The July 1986 double elections resulted in the largest majority for the ruling Liberal Democratic Party in its 30-year history, a stunning victory for Prime Minister Yasuhiro Nakasone. The momentum established by the electoral victory carried over into the extraordinary session and provided the impetus necessary to secure approval of the JNR reorganization bill, by far the most controversial and sensitive of the major administrative reform measures approved by the government over the last two years. (Previous bills privatized the organizations that monopolized the domestic markets for telecommunications equipment and services and tobacco products.)

The new Diet will reconvene January 26 to face a series of tough choices on the budget for the year starting April 1. Increased defense spending will rank among the most difficult issues, particularly in light of the fact that total spending will exceed the 10-year-old limit of 1 percent of the country's gross national product. The Diet will also have to grapple with tax reform (see articles in this issue).

The new session may also consider controversial proposals to institute anti-espionage laws. The Nakasone government reportedly had hoped to introduce